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USOECD

USEEC ALSO FOR EMBASSY

PASS TREASURY FOR UNDER SECRETARY SOLOMON AND WIDMAN,
FRB FOR GOVERNOR WALLICH, CEA FOR NORDHAUS AND SHAFER

E.O. 11652: GDS
TAGS: ECON, EFIN, OECD
SUBJECT: OECD ECONOMIC POLICY COMMITTEE'S WORKING PARTY
3 MEETING MAY 31

REF: A) PARIS 14537, B) PARIS 17725, C) PARIS 6671,
D) PARIS 16969

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SUMMARY

1. ONE-DAY MEETING OF WP-3 ON MAY 31 FOCUSED
ESSENTIALLY ON WHAT FACTORS MAY UNDERLIE RELATIVE
STABILITY IN EXCHANGE MARKETS OVER PAST COUPLE OF
MONTHS AND WHETHER THIS SITUATION OF GREATER CALM
WAS LIKELY TO BE SUSTAINED. DEBATE LED TO NO
FIXED CONCLUSIONS, BUT PREVAILING VIEW SEEMED TO BE

THAT PSYCHOLOGICAL FACTORS WERE IMPORTANT AND THAT MAINTENANCE OF CONFIDENCE IMPORTANTLY RELATED TO MARKET PERCEPTIONS ABOUT POLICIES AFFECTING THE FUNDAMENTAL PERFORMANCE OF ECONOMIES. THERE SEEMED TO BE A WIDESPREAD FEELING, HOWEVER, THAT INFLUENCING SUCH FUNDAMENTALS TO THE DEGREE OF BRINGING ABOUT SUBSTANTIAL CHANGES IN REAL ECONOMIC RELATIONSHIPS WOULD TAKE SOME TIME. IN THE INTERVAL, AS WP-3 CHAIRMAN MATSUKAWA PUT IT, WE SEEM TO BE LEFT WITH TRYING TO PROVIDE "GOOD NEWS FLOWING THROUGH THE ANNOUNCEMENT OF FAVORABLE POLICY INTENTIONS", SUCH AS THOSE IMPLIED BY THE CURRENT DISCUSSIONS ABOUT CONCERTED ACTION.

2. RELATED TO THIS MAIN THEME, WP-3 ALSO TOUCHED ON: (A) THE MARGIN OF MONETARY POLICY MANOEUVRE AVAILABLE TO STRUCTURE INTEREST RATE DIFFERENTIALS IN A WAY TO HELP OFFSET OTHER FACTORS OPERATING ON EXCHANGE MARKETS; (B) THE ROLE OF INTERVENTION; (C) THE FUNCTION OF THE CAPITAL ACCOUNT AND THE APPROPRIATE LONG-TERM STRUCTURE OF CAPITAL FLOWS IN TODAY'S CIRCUMSTANCES; AND (D) THE APPROPRIATENESS OF CAPITAL CONTROLS AS A MEASURE TO STABILIZE EXCHANGE MARKETS.

3. WP MEETING WAS UNUSUALLY LIVELY WITH A GOOD DEAL OF SPONTANEOUS COMMENTARY AND QUESTIONING ACROSS THE CONFIDENTIAL

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TABLE. ON THE WHOLE WP-3 ATMOSPHERE WAS LESS CONTENTIOUS AND LESS CRITICALLY FOCUSED ON U.S. POLICIES THAN HAD BEEN THE CASE AT PREVIOUS MEETING IN FEBRUARY (REFTEL C). NEXT WP-3 WILL BE HELD SEPTEMBER 23 IN WASHINGTON PRIOR TO IMF ANNUAL MEETING. END SUMMARY

CHAIRMAN'S AND SECRETARIAT'S INTRODUCTION AND CHAIRMAN'S SUMMATION

4. WP-3 BEGAN WITH STATEMENT FROM CHAIRMAN MATSUKAWA SEEKING TO CHARACTERIZE CURRENT SITUATION. HE NOTED THAT RELATIVE STABILITY HAD BEEN RESTORED TO EXCHANGE MARKETS SINCE EARLY APRIL FOLLOWING THE TURBULENCE IN THE LAST QUARTER OF LAST YEAR AND FIRST PART OF THIS YEAR. HE CITED THE VARIOUS STEPS TAKEN BY U.S. AUTHORITIES "TO PROTECT THE INTEGRITY OF THE DOLLAR" (INCLUDING THE JOINT U.S.-GERMAN ANNOUNCEMENT OF MARCH 13, THE STRENGTHENED ANTI-INFLATION STANCE OF THE U.S. GOVERNMENT AND THE TREASURY ANNOUNCEMENT OF GOLD SALES) AS ALL HAVING PLAYED A POSITIVE ROLE. MATSUKAWA ALSO REVIEWED GROWTH TRENDS, THE LIKELY EVOLUTION OF LARGE INDIVIDUAL CURRENT ACCOUNT SURPLUSES AND DEFICITS, THE OUTLOOK FOR THE OPEC SURPLUS, AND THE

STATUS OF THE CONSIDERATION OF CONCERTED ACTION.
GENERALLY, MATSUKAWA'S PRESENTATION WAS SIMILAR TO
THAT FOUND IN THE SECRETARIAT'S DOCUMENTATION FOR EPC
AND WP-3.

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5. SECRETARIAT (FAY) SUMMARIZED RESULTS OF EPC MEETING
MAY 29-30 (SEE REFTEL B). FAY PARTICULARLY EMPHASIZED
ROLE THAT EACH INDIVIDUAL COUNTRY WOULD HAVE UNDER
CONCEPT OF CONCERTED ACTION AS WELL AS THE INTER-
RELATIONSHIPS AMONG DEMAND MANAGEMENT, STABILIZATION
POLICIES, ADJUSTMENT POLICIES, ENERGY POLICIES, AND
CONDITIONS ON EXCHANGE MARKETS. HE NOTED THAT THE
LATTER SUBJECT HAD RECEIVED LITTLE ATTENTION IN EPC
AND HOPED TO OBTAIN GUIDANCE FROM WP-3'S DISCUSSION
FOR HANDLING THIS ISSUE IN THE MINISTERIAL MEETING.

6. AT THE END OF THE DAY, CHAIRMAN MATSUKAWA SUMMARIZED
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THE RESULTS OF THE WP-3 MEETING, ROUGHLY IN THE
FOLLOWING TERMS:

A) THE DISCUSSION STARTED FROM ANALYSIS OF THE PRESENT
RELATIVE STABILITY IN THE FOREIGN EXCHANGE MARKET AND
THE QUESTION OF WHETHER THE PRESENT STABILITY CAN BE
SUSTAINED. IT LED TO CONSIDERING HOW THE CURRENT
LULL CAN BEST BE USED TO STRENGTHEN THE INTERNATIONAL
MONETARY SYSTEM.

B) THE GENERAL PICTURE OF THE WORLD ECONOMY IS NOT YET
SATISFACTORY, ALTHOUGH THERE ARE MOVEMENTS IN THE RIGHT
DIRECTION. IT SEEMS THAT THE MAIN CHANGE HAS BEEN IN
MARKET CONFIDENCE AND EXPECTATIONS AND PERCEPTIONS OF THE
POLICY STANCE OF THE U.S. IN THIS CONNECTION, U.S.
DELEGATES EMPHASIZED THAT CONFIDENCE IS ESSENTIAL FOR
STABILITY IN EXCHANGE MARKETS, AND REAFFIRMED THAT THE
U.S. WILL CONTINUE TO BE PREPARED TO INTERVENE TO
PREVENT DISORDERLY MARKETS.

C) THE DISCUSSION INDICATED THAT IN MANY COUNTRIES THERE
IS LITTLE IMMEDIATE EXPECTATION OF CHANGES IN MONETARY
OR OTHER DOMESTIC POLICIES AND WE SEEM TO BE LEFT WITH
THE EFFECT OF GOOD NEWS FLOWING THROUGH THE ANNOUNCEMENT
OF FAVORABLE POLICY INTENTIONS. PERHAPS THE CONCEPT
OF CONCERTED ACTION MAY SERVE SUCH PURPOSE UNTIL THE
INTERNATIONAL DISCUSSIONS OVER THE NEXT SEVERAL
WEEKS BRING SOMETHING MORE CONCRETE.

D) THE DESIRABILITY OF COORDINATION IN MONETARY
CONDITIONS WAS MENTIONED ESPECIALLY WITH RESPECT TO
THE STRUCTURE OF INTEREST RATES AND THE NEED FOR
CAPITAL FLOWS TO FINANCE CURRENT ACCOUNT SURPLUSES
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AND DEFICITS, ALTHOUGH THE LIMITED MARGINS FOR
MANOEUVRE IN DOMESTIC MONETARY MANAGEMENT IN MOST
COUNTRIES WERE RECOGNIZED.

E) THERE WAS A RELUCTANCE TO PLACE RELIANCE ON
CAPITAL CONTROLS ON A LONG TERM BASIS, ALTHOUGH
SOME FELT THAT SUCH CONTROLS MIGHT BE USEFUL AS A
TEMPORARY EMERGENCY MEASURE TO COUNTER

VOLATILE SHORT TERM FLOWS IN CERTAIN SITUATIONS AND CIRCUMSTANCES (LATTER PHRASE ADDED AFTER OBJECTIONS FROM U.S. DEL - SOLOMON).

F) THERE WAS AN EXCHANGE OF VIEWS ON QUESTIONS OF CAPITAL EXPORTS AND THE APPROPRIATE LONG TERM STRUCTURE OF CAPITAL FLOWS. SOME POINTED TO THE NEED TO PAY MORE ATTENTION TO THE CHARACTER OF CAPITAL FLOWS.

REASONS FOR AND SUSTAINABILITY OF RECENT CALMING OF EXCHANGE MARKETS

7. BY PREARRANGEMENT, MATSUKAWA ASKED U.K. DELEGATE (MCMAHON) TO MAKE KEYNOTE STATEMENT SEEKING TO DIAGNOSE REASONS FOR RECENT TURNAROUND IN EXCHANGE MARKET CONDITIONS AND TO WEIGH WHETHER THIS RELATIVE STABILITY WAS LIKELY TO CONTINUE. MCMAHON NOTED THAT THERE HAD BEEN LITTLE POSITIVE CHANGE IN REAL FACTORS. THUS, THERE HAD BEEN NO REDUCTION IN CURRENT ACCOUNT DISEQUILIBRIA WITHIN THE OECD, INFLATIONARY EXPECTATIONS IN THE UNITED STATES WERE WORSE, AND QUESTIONS ABOUT U.S. ENERGY POLICY HAVE NOT BEEN RESOLVED. WHILE THE IMPOSITION OF CAPITAL CONTROLS BY SWITZERLAND AND JAPAN MAY HAVE HAD SOME EFFECTS, MCMAHON DID NOT BELIEVE THAT EITHER THESE CONTROLS OR THE SUBSTANTIAL INTERVENTION THAT HAD TAKEN PLACE IN THE MARKETS PROVIDED A SATISFACTORY EXPLANATION. RATHER, MCMAHON ADDUCED THAT THE KEY FACTOR HAD BEEN A CHANGE IN PERCEPTIONS BY THE MARKET

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ABOUT THE EMPHASIS IN U.S. POLICIES. HE CITED IN

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PARTICULAR THE THREE POLICY ANNOUNCEMENTS ALREADY MENTIONED BY MATSUKAWA (PARA 4 ABOVE) ADDING HIGHER INTEREST RATES AS A RESULT OF FEDERAL RESERVE ACTIONS AND THE IMPROVEMENT IN WALL STREET. WHILE SAYING THAT THE WEIGHT OF EACH INDIVIDUAL ANNOUNCEMENT BY THE UNITED STATES WAS NOT LARGE, THE CUMULATIVE EFFECT WAS SUBSTANTIAL AND THE U.S. SHOULD BE CONGRATULATED. MCMAHON THOUGHT IT WAS INTERESTING THAT CONTRARY TO MUCH HISTORICAL PRECEDENT, RECENT PRICE MOVEMENTS OF GOLD AND DOLLARS HAVE BEEN IN THE SAME DIRECTION; THIS WAS A CURIOUS FACT, EVEN IF THE EXPLANATION IS NOT CLEAR.

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8. ON THE OUTLOOK, MCMAHON NOTED THAT THERE IS LITTLE EARLY PROSPECT OF NARROWING THE CURRENT ACCOUNT IMBALANCES IN THE OECD AND THE ALGEBRAIC SUM OF THESE SURPLUSES AND DEFICITS WILL CONTINUE TO BE VERY HIGH. ON INFLATION RATES, HE THOUGHT THERE IS SOME--BUT NOT MUCH--PROSPECT FOR NARROWING DIFFERENTIALS IN RATES AND THERE SHOULD ALSO BE SOME MORE "HARMONIZATION" AMONG MONETARY POLICIES. IN GROWTH RATES TOO, HE FINDS A TREND TOWARD NARROWING OF DIFFERENTIALS, BUT UNFORTUNATELY A DOWNWARD RATHER THAN UPWARD LEVELING.

9. MCMAHON THOUGHT THAT WHILE THERE WERE SOME COMFORTING FACTORS IN PROSPECT, ARGUING FOR THE POSSIBILITY OF MAINTAINING RELATIVE EXCHANGE MARKET STABILITY FOR SOME TIME, THERE WERE RISKS AGAINST IT. BASICALLY, IT IS DIFFICULT TO MAINTAIN EXCHANGE RATE

STABILITY AMONG MAJOR CURRENCIES FOR ANY PERIOD OF TIME. WE SHOULD NOT BE SURPRISED AT A RENEWAL OF INSTABILITY. WE SHOULD BE ON GUARD, PARTICULARLY GIVEN THE EXPECTATIONS THAT SURROUND THE VARIOUS INTERNATIONAL MEETINGS SCHEDULED OVER THE COMING WEEKS.

10. MCMAHON UNDERLINED THE IMPORTANCE FOR LONGER TERM STABILITY OF (A) CONCERTED ACTION PROGRAM, (B) EQUILIBRATING CAPITAL FLOWS FROM SURPLUS TO DEFICIT COUNTRIES, AND (C) HARMONIZATION AMONG NATIONAL MONETARY POLICIES. HE ALSO UNDERSCORED VITALIZING IMF SURVEILLANCE UNDER THE REVISED ARTICLE IV AS WELL AS THE CONTINUATION OF INTERVENTION POLICIES WHICH HE INDICATED WERE NOT WHOLLY INEFFECTIVE EVEN IF THEY ARE NOT CAPABLE OF STOPPING A BASIC TREND. FINALLY, MCMAHON SAID THAT WE MUST PAY MORE ATTENTION TO ANALYZING AND UNDERSTANDING SOME OF THE UNDERLYING

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FORCES AT WORK SUCH AS THE EFFECT OF SHIFTS IN ASSET PREFERENCES OF INVESTORS.

11. DUTCH DEL (VAN ITTERSUM) AGREED ON A CAUTIOUS READING, WARNING THAT EXCHANGE MARKETS COULD BE DISAPPOINTED AFTER THE BONN SUMMIT. AN OECD CONCERTED ACTION EFFORT WILL BE ESSENTIAL TO NARROW DISPARITIES IN CURRENT ACCOUNT BALANCES. HE HOPED THAT U.S. WOULD GIVE DUE WEIGHT TO EXTERNAL CONSIDERATIONS IN SETTING ITS POLICIES; HE WELCOMES THE CUTBACK IN THE ADMINISTRATION'S TAX PROPOSALS. CANADIANS (HOOD) FELT THAT WE WERE WITHIN SIGHT OF IMPROVEMENT ON FUNDAMENTALS AND THAT THE SECRETARIAT HAD OVER-ESTIMATED THE TIME LAGS IN HAVING EXCHANGE RATE CHANGES TRANSLATED INTO REAL EFFECTS. HE EMPHASIZED THAT BALANCE-OF-PAYMENTS ADJUSTMENT MEANS FOLLOWING THE RIGHT POLICIES AND THAT THIS POINT SHOULD BE MADE TO THE OECD MINISTERS.

12. GERMAN DEL (POEHL) SAID HE WAS MORE CONCERNED THAN MCMAHON ABOUT DANGER OF INFLATION, WHICH RELATED BOTH TO EXCHANGE MARKET UNCERTAINTY AND TO LOW ECONOMIC GROWTH. ON BALANCE, HOWEVER, POEHL FELT THERE WERE SUBSTANTIAL REASONS FOR EXPECTATION STABILIZATION OF EXCHANGE MARKETS. THERE HAS BEEN A SIGNIFICANT CHANGE IN GERMANY'S EXTERNAL POSITION OVER THE PAST THREE MONTHS. CAPITAL OUTFLOWS HAVE RISEN AND THE BUNDESBANK'S RESERVES NOW ARE VIRTUALLY UNCHANGED FROM THEIR LEVEL AT BEGINNING OF YEAR. GERMAN LIABILITIES IN DM ARE GROWING AND CONSERVATIVE ESTIMATES ARE THAT 7 - 8 PERCENT OF ALL OFFICIAL RESERVES ARE NOW HELD IN DM, THUS

MAKING MARK SECOND MOST IMPORTANT RESERVE
CURRENCY. IN GENERAL GERMANS (WEBER AND POEHL)
REITERATED FAMILIAR GERMAN EXPECTATION OF REDUCED
CURRENT ACCOUNT SURPLUS AS IMPORT VOLUME CONTINUES TO
GROW MUCH FASTER THAN DOMESTIC DEMAND AND GERMAN
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WILLINGNESS TO EXPORT CAPITAL TO OFFSET CURRENT ACCOUNT
BALANCE (SEE ALSO PARA 28 BELOW).

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13. POEHL DID NOT EXCLUDE POSSIBILITY OF ADDITIONAL
STIMULATORY MEASURES BY GERMANY BUT ARGUED ROOM FOR

STIMULATION IS EXTREMELY LIMITED.

14. U.S. DEL (SOLOMON), WHILE AGREEING THAT WORLD ECONOMIC OUTLOOK NOT SATISFACTORY AND THAT CONCERTED ACTION NEEDED, CAUTIONED AGAINST EXCESS PESSIMISM. AS POSITIVE FACTORS, HE CITED PROSPECT OF SOME CONVERGENCE OF GROWTH RATES IN 1978, SOME SPEEDING UP OF OVERALL 1978 OECD AREA GROWTH AND (IN CONTRAST TO SECRETARIAT) INCREASE RATHER THAN DECREASE IN IMPORTS BY NON-OIL LDC'S. ALL THIS SHOULD LEAD TO SIGNIFICANT
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PROGRESS IN ADJUSTING PAYMENTS IMBALANCES. FURTHERMORE, DEPRECIATION OF DOLLAR IN LATE 1977 - EARLY 1978 SHOULD HELP U.S. COMPETITIVE SITUATION BY LATE 1978 AND INTO 1979. FIRST QUARTER 1978 RESULTS (TRADE DEFICIT \$11 BILLION AND SEASONALLY ADJUSTED CURRENT ACCOUNT DEFICIT ON ORDER OF \$9 BILLION) INFLATED BY EXTRAORDINARY FACTORS AND SHOULD IMPROVE OVER REMAINDER OF YEAR. HOWEVER, 1978 CURRENT ACCOUNT DEFICIT LIKELY TO BE IN \$22 - \$25 BILLION RANGE.

15. SOLOMON SAID THAT THE QUESTION OF HOW MUCH FURTHER IMPROVEMENT MAY BE ACHIEVED IN 1979 OVER THE LIKELY SECOND HALF 1978 DEFICIT DEPENDS ON HIGHLY UNCERTAIN FACTORS, INCLUDING PARTICULARLY THE STRENGTH OF EXPANSION OF U.S. OVERSEAS MARKETS AND THE SUCCESS OF U.S. EXPORTERS IN MAINTAINING OR IMPROVING MARKET SHARES. MECHANICALLY A ONE PERCENT DIFFERENCE IN U.S. GROWTH RATES WOULD IMPLY A \$5 - \$6 BILLION DIFFERENCE IN THE TRADE BALANCE, BUT WE QUESTIONED THE APPROPRIATENESS OF THESE RELATIONSHIPS OF RECENT YEARS BECAUSE (A) THERE HAVE BEEN IMPORTANT STRUCTURAL CHANGES FOR EXAMPLE THE ENERGY INPUT/GNP OUTPUT; (B) THE EFFECT OF POLICY CHANGES BOTH IN THE U.S. AND ABROAD; AND (C) RAPID DEVELOPMENTS OUTSIDE OF THE OECD. U.S. QUESTIONS THE SECRETARIAT'S FIGURE OF \$19 BILLION ANNUAL RATE OF CURRENT ACCOUNT DEFICIT FOR THE FIRST HALF OF 1979, ALTHOUGH WE ARE NOT AT THIS TIME PREPARED TO SUGGEST AN ALTERNATIVE FIGURE. IN GENERAL, SOLOMON QUESTIONED WHETHER QUANTITATIVE FORECASTS BASED ON THE OECD'S "NO POLICY CHANGE" ASSUMPTION ARE USEFUL WHEN POLICY CHANGES ARE UNDER WAY.

16. SOLOMON SAID THAT DEVELOPMENTS IN EXCHANGE
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MARKETS DURING APRIL - MAY, AND U.S. ANALYSIS OF HOW THEY RELATE TO DEVELOPMENTS DURING THE LAST QUARTER OF 1977 AND THE FIRST QUARTER OF 1978 LEADS US TO BE MORE CONFIDENT THAN SECRETARIAT THAT RECENT FIRMER DOLLAR AND BETTER EXCHANGE MARKET TONE CAN BE SUSTAINED. SOLOMON NOTED THAT:

- THE U.S. HAS BEEN EXPERIENCING A SUBSTANTIAL PRIVATE CAPITAL INFLOW DURING APRIL - MAY AND OFFICIAL DOLLAR HOLDINGS OF ALL G-10 MEMBERS APPARENTLY FELL BY MORE THAN \$2 BILLION DURING THESE TWO MONTHS.

- MARKET EXPECTATIONS ARE IMPORTANT. THESE EXPECTATIONS HAVE LED TO THE TURN-AROUND IN THE EXCHANGE MARKETS AND HAVE RESULTED FROM THE POSITIVE PUBLIC ASSESSMENT OF GOVERNMENT POLICIES, LARGELY THE U.S. INTENT TO TACKLE INFLATION AND TO ACT ON ENERGY.

- WHAT HAPPENS IN MARKETS IN MONTHS AHEAD DEPENDS HEAVILY ON SUCCESS IN IMPLEMENTING POLICIES, NOT JUST IN THE U.S., BUT IN GOING FORWARD WITH A CONCERTED APPROACH.

- STABLE MARKETS SHOULD NOT BE EQUATED WITH STABLE RATES. DECLARING FIXED RATES OR TARGET ZONES IN THE FACE OF EXISTING DIFFERENCES AND UNDERLYING CONDITIONS WOULD NOT FOOL MARKETS. RATE MOVEMENTS IN RESPONSE TO REALITY MUST BE ACCEPTED, BUT THEY NEED TO PROCEED IN AN ORDERLY WAY.

- THE LIKELIHOOD OF MAINTAINING STABLE MARKETS AND I REDUCING THE AMOUNT OF RATE MOVEMENT DEPENDS ON THE MARKET'S APPRAISAL OF THE VALUE OF BASIC POLICIES BOTH IN DEFICIT AND IN SURPLUS COUNTRIES. COOPERATION ON INFLATION POLICIES, GROWTH POLICIES, TRADE AND ENERGY CAN BE EFFECTIVE IN PROMOTING MARKET STABILITY
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AND IN TURN MAKING IT EASIER TO GET GROWTH.

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- PERIOD AHEAD IS DIFFICULT BECAUSE ADJUSTMENT OF
CURRENT ACCOUNT BALANCES WILL TAKE TIME. IT IS
IMPORTANT TO MAINTAIN CONFIDENCE AND WHILE
IMPLEMENTATION OF PROPER POLICIES IS KEY, WE MUST
ALSO WORK TOGETHER TO COUNTER DISORDER IN THE MARKETS.
U.S. IS PREPARED TO INTERVENE TO EXTENT NECESSARY TO
ACHIEVE THIS LIMITED OBJECTIVE.

17. JAPAN (HIRIO) ARGUED THAT JAPAN'S EXPORT VOLUME
HAS BEEN DECLINING AND IMPORT VOLUME HAS BEEN
INCREASING. JAPAN IS DOING ITS PART IN CONCERTED
ACTION IN THAT ITS TARGET FOR JFY 1978 IS SET AT THE
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7 PERCENT PRESCRIBED BY THE SECRETARIAT. JAPAN IS
PREPARED TO TAKE FURTHER ACTION IF NECESSARY TO REACH
THIS TARGET.

18. JAPANESE ACKNOWLEDGED THAT EFFECT OF EXCHANGE
RATE APPRECIATION ON EXPORTS IS DIFFICULT TO ESTIMATE.
THE TIME LAGS AND ELASTICITIES WERE UNCERTAIN.

GIVEN THE STRUCTURE OF THE JAPANESE ECONOMY, APPRECIATION HAD BENEFICIAL EFFECTS ON COSTS (BOTH RAW MATERIAL IMPORT PRICES AND WAGE INCREASES).

19. SWISS (LANGUETIN) UNDERLINED THAT THE INCREASED ANTI-INFLATIONARY TILT OF U.S. POLICY HAS HAD A VERY POSITIVE EFFECT ON EXCHANGE MARKETS, BEING A REMARKABLE EXAMPLE OF CHANGE IN EXPECTATIONS. THERE IS LINKAGE BETWEEN EXCHANGE RATE STABILITY AND FUNDAMENTAL POLICIES. IT IS TRUE THAT SETTING FUNDAMENTAL POLICIES IN THE RIGHT DIRECTION HELPS TO ESTABLISH EXCHANGE STABILITY, BUT EXCHANGE STABILITY IS ALSO USEFUL TO GET GOVERNMENT POLICIES RIGHT. THIS IS BECAUSE, ESPECIALLY IN SMALL OPEN ECONOMIES, EXCESSIVE FLUCTUATIONS IN EXCHANGE MARKETS INHIBIT GOVERNMENT POLICIES OF RESTRUCTURING AND CAUSE BUSINESS UNCERTAINTY BOTH OF WHICH HAMPER ECONOMIC GROWTH.

20. BELGIUM (JANSON) SAID EXCHANGE MARKETS REFLECT FUNDAMENTAL DIFFERENCE IN CURRENT ACCOUNT DEFICITS AND THE FACT THAT THE U.S. ECONOMY IS CONSTANTLY "UNDER A MICROSCOPE". THE US HAS HAD A DEFICIT BOTH ON CURRENT ACCOUNT AND ON CAPITAL ACCOUNT AND THIS WAS NOT COMPATIBLE WITH STABILITY OF THE SYSTEM. IF A COUNTRY HAS A CURRENT ACCOUNT DEFICIT WHILE DOING NOTHING TO

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TRY TO HALT CAPITAL OUTFLOW, IT CAN BE ACCUSED OF DELIBERATELY DESIRING DEPRECIATION.

21. BIS REP (LAMFALUSSY) SUGGESTED THAT THE REVERSAL IN THE POSITION OF THE DOLLAR MAY HAVE BEEN DUE TO REVERSAL OF SPECULATIVE POSITIONS. AT THE END OF LAST YEAR AND DURING THE FIRST PART OF 1978 BANKS AND NON-BANKS APPEAR TO HAVE TAKEN SUBSTANTIALLY SHORT POSITIONS IN DOLLARS (OF WHICH A LARGE PART WAS ON A 3-MONTH BASIS). WHILE THESE ARRANGEMENTS DID NOT HAVE TO BE AUTOMATICALLY UNWOUND AND COULD HAVE BEEN ROLLED OVER, THE FACT SEEMS TO BE THAT THE SHORT POSITIONS WERE COVERED. NEVERTHELESS, THE SITUATION IS STILL FRAGILE AND IF WE WANT TO KEEP THE IMPROVEMENT GOING, WE SHOULD HEED MATSUKAWA'S ADVICE ABOUT SHOWING GOOD POLICY INTENTIONS AS WELL AS TO KEEP MONETARY POLICY IN A POSTURE CONDUCIVE TO DISCOURAGING SPECULATIVE MOVEMENTS.

22. THESE STATEMENTS WERE INTERSPERSED WITH AN ACTIVE EXCHANGE OF QUESTIONS AND COMMENTS. PERHAPS THE MOST INTERESTING INVOLVED U.S. (SOLOMON) QUESTIONING EUROPEANS ON WHY THEY SEEMED TO HAVE ASYMMETRICAL

PREOCCUPATION WITH EXCHANGE RATE MOVEMENTS, I.E.,
WHY THERE WERE ALARMS WHEN THE DOLLAR DEPRECIATED
BUT NOT SIMILAR CONCERN WHEN DOLLAR MOVED IN
APPRECIATING DIRECTION. SOLOMON SAID HE REALIZED THAT
HOLDERS OF DOLLAR ASSETS WOULD BE LOATH TO SEE THE
VALUE OF SUCH ASSETS DECLINE, BUT ABSTRACTING FROM
THIS FACTOR, HE WONDERED WHY GERMANS AND OTHER EUROPEANS
SEEMED TO PLACE SO MUCH WEIGHT ON MOVEMENT OF BILATERAL
EXCHANGE RATE WITH DOLLAR, WHEN ON TRADE-WEIGHTED
BASIS THEIR CURRENCIES HAD SHOWN RELATIVELY LITTLE
FLUCTUATION. IN REPLY TO SOLOMON, BELGIAN DELEGATE
(VAN YPERSELE) ARGUED THAT EUROPEAN CONCERN ABOUT THE
MOVEMENT OF THE DOLLAR RATE WAS ROOTED IN VARIOUS
ELEMENTS, ESPECIALLY:
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- THE DEGREE OF OPENNESS OF EUROPEAN ECONOMIES. IN

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-----013653 100617Z /11

R 091623Z JUN 78
FM AMEMBASSY PARIS
TO SECSTATE WASHDC 2970
INFO AMEMBASSY BERN
AMEMBASSY BONN
AMEMBASSY BRUSSELS
AMEMBASSY THE HAGUE
AMEMBASSY LONDON
AMEMBASSY OTTAWA
AMEMBASSY ROME
AMEMBASSY STOCKHOLM

AMEMBASSY TOKYO

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SOME OPEN ECONOMIES, MOVEMENT OF THE DOLLAR RATE MAY HAVE SPECIAL IMPORTANCE FOR SPECIFIC EXPORT SECTORS SO THAT THIS BILATERAL EXCHANGE RATE MOVEMENT MIGHT DEPRESS SECTORS REPRESENTING SEVERAL PERCENTAGE POINTS OF GNP.

- UNCERTAINTY AND INSTABILITY IN THE DOLLAR RATE MAY HAVE DEPRESSING EFFECTS ON THE ECONOMY AS A WHOLE BOTH PSYCHOLOGICALLY AND IN REAL TERMS. THUS, THE EFFECT OF EROSION OF PROFIT MARGINS MAY SERIOUSLY AFFECT BUSINESS EXPECTATIONS AND PLANS (EVEN IF DOLLAR SNAPS BACK LATER).

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- GIVEN THE ROLE OF THE DOLLAR AS A RESERVE INSTRUMENT, UNCERTAINTIES GENERATED BY MOVEMENTS IN AND OUT OF THE DOLLAR TEND TO AGGRAVATE TENSIONS AMONG EUROPEAN CURRENCIES.

23. GERMANY (POEHL) ALSO UNDERScoreD THE PROBLEM OF CREATING TENSIONS IN THE SNAKE. SOLOMON COMMENTED THAT WE SHOULD ALL KEEP OUR EYE ON THE TOTAL SITUATION AND NOT LET VESTED INTERESTS FROM PRODUCERS AND EXPORTERS THAT MAY BE HIT BY BILATERAL CHANGES IN EXCHANGE RATES EXERT UNDUE INFLUENCE ON POLICIES WHICH OUGHT TO BE SET IN RELATION TO THE AGGREGATE POSITION OF THE ECONOMY.

MONETARY POLICY AND INTEREST RATE DIFFERENTIALS

24. WP-3 DISCUSSION SHOWED THAT MOST EUROPEANS CONTINUE TO PLACE CONSIDERABLE EMPHASIS ON MONETARY POLICY AND INTEREST RATE DIFFERENTIALS AS MEANS OF HELPING TO OFFSET OTHER INFLUENCES ON THE EXCHANGE MARKET AND TO HELP STABILIZE RATES. THE MESSAGE CONVEYED, BOTH DIRECTLY AND INDIRECTLY, WAS ESSENTIALLY THAT THE U.S. SHOULD GIVE DUE WEIGHT TO INTERNATIONAL CONSIDERATIONS AND NOT HESITATE UNDULY IN RAISING INTEREST RATES AS ONE WAY OF HELPING TO STABILIZE THE DOLLAR EXCHANGE RATE. IN CONTRAST TO OTHER RECENT MEETINGS OF WP-3, THERE WERE NO PARTICULAR WORRIES RAISED THAT INTEREST RATE INCREASES IN THE UNITED STATES MIGHT HAVE DAMPENING EFFECT ON THE U.S. GROWTH RATE. THIS KIND OF EMPHASIS ON MONETARY POLICY WAS ADVANCED PARTICULARLY BY THE U.K.

(MCMAHON), DUTCH (VAN ITTERSUM), BIS (LAMFALUSSY), AND OECD SECRETARIAT. GERMANS (POEHL), HOWEVER, DID NOT AGREE THAT FOR THEM AN EASIER MONETARY POLICY WAS AN ANSWER TO UPWARD PRESSURE ON THE DM. POEHL NOTED THAT
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THE GERMAN MONEY SUPPLY HAD EXPANDED TOO QUICKLY AT THE END OF LAST YEAR WHEN MASSIVE INTERVENTIONS TOOK PLACE, AND THAT EXPANSION AT SUCH RATE COULD NOT GO ON. AS IT IS, THE 1978 MONETARY TARGET WOULD HAVE TO BE EXCEEDED. GERMAN INTEREST RATES HAVE ALREADY INCREASED OVER THE ENTIRE SPECTRUM AND THE EFFECT OF ANY ADDITIONAL FISCAL MEASURES COULD EASILY BE VITIATED BY HIGHER INTEREST RATES.

25. U.S. (WALLICH) INDICATED THAT DURING RECENT MONTHS THERE HAS BEEN A HIGH DEGREE OF COINCIDENCE BETWEEN U.S. FOREIGN AND DOMESTIC OBJECTIVES IN MONETARY POLICY. WE ARE NOT IN A DILEMMA CASE. IN REAL TERMS, INTEREST RATES IN THE U.S. HAVE MOVED TO A SIGNIFICANTLY POSITIVE LEVEL AND INTERNATIONAL INTEREST RATE DIFFERENTIALS NOW BROADLY MATCH DIFFERENTIALS IN INFLATION RATES. U.S. MONETARY POLICY WAS IN EFFECT WORKING WITHIN A BAND WHICH TOOK INTO ACCOUNT THE UPSIDE RISK OF DISINTERMEDIATION IN THE DOMESTIC SYSTEM AND THE DOWNSIDE RISK DEFINED BY THE INTERNATIONAL SITUATION. CERTAINLY FOREIGN CONSIDERATIONS ARE KEPT IN MIND BY THE FEDERAL RESERVE. WALLICH FELT THAT SECRETARIAT'S REFERENCE TO COORDINATION OF MONETARY POLICY WAS NOT PARTICULARLY APT. THERE HAS BEEN GOOD COORDINATION ON INTERVENTION POLICY AND PERHAPS THE BEST TYPE OF COORDINATION OF DOMESTIC MONETARY POLICIES INTERNATIONALLY IS FOR EACH COUNTRY TO BRING ITS MONETARY AGGREGATES UNDER BETTER CONTROL.

INTERVENTION POLICY

26. MOST SPEAKERS ACKNOWLEDGED THAT EXCHANGE MARKET INTERVENTION COULD NOT AND SHOULD NOT BE USED TO COUNTER BASIC TRENDS IN THE EXCHANGE MARKETS, ALTHOUGH SOME, E.G. ITALY (PALUMBO), POINTED TO THE IMPORTANT ROLE OF INTERVENTION AND LANGUETIN SUGGESTED THAT "MORE AGGRESSIVE INTERVENTION" MIGHT AT TIMES BE
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REQUIRED. IN GENERAL, HOWEVER, THERE SEEMED TO BE CONSIDERABLE IMPLICIT SATISFACTION WITH THE DEGREE OF

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AMEMBASSY STOCKHOLM
AMEMBASSY TOKYO

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INTERVENTION THAT HAD TAKEN PLACE AND THE KIND OF
RESOURCES THAT HAD BEEN COMMITTED UNDER THE U.S.-GERMAN
ANNOUNCEMENT IN MARCH. SOLOMON NOTED THAT U.S. POLICY
ON THE QUESTION OF ISSUING FOREIGN CURRENCY
DENOMINATED BONDS REMAINED THE SAME AS HE HAD EXPRESSED
AT THE FEBRUARY WP-3 MEETING. HE NOTED THAT THE
RESOURCES TO COUNTER SPECULATION AVAILABLE TO THE
U.S. ARE VERY LARGE. WE DO NOT AT PRESENT FEEL IT
NECESSARY TO RAISE ADDITIONAL RESOURCES THROUGH
FOREIGN BORROWING CONSIDERING THE BALANCE OF
ADVANTAGES AND DISADVANTAGES OF TAKING SUCH ACTION.

27. IN ANSWER TO A QUESTION ON WHAT LESSONS U.S. MAY
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HAVE LEARNED ON INTERVENTION TECHNIQUES, SOLOMON REPLIED THAT MARKET INTERVENTION IS MOST EFFECTIVE WHEN COMBINED WITH POLICY ACTIONS AND POLICY ANNOUNCEMENTS WITH RESPECT TO THE FUNDAMENTALS. IN THE ABSENCE OF SUCH A LINK TO POLICY, INTERVENTION SIMPLY SMOOTHS THE CURRENCY MOVEMENT OR MAY PERVERSELY EVEN CALL FORTH MORE SPECULATION. MARKET PSYCHOLOGY IS INFLUENCED NOT SO MUCH BY THE TECHNIQUE OF THE TRADING DESK AS BY ACTIONS ON THE FUNDAMENTALS AND BY MARKET PERCEPTIONS OF THEM. FREQUENTLY, THE SAME ACTION WHEN TAKEN ON A RISING CREST OF EXPECTATIONS CAN BE VERY POSITIVE, WHEREAS IT COULD HAVE THE OPPOSITE REACTION IN A BEAR MARKET (FOR EXAMPLE THE TIMING OF THE ANNOUNCEMENT OF U.S. GOLD SALES WAS DETERMINED WITH THIS CONSIDERATION IN MIND).

CAPITAL ACCOUNT

28. WP-3 HAD A SOMEWHAT DISJOINTED AND UNFOCUSED DISCUSSION OF CAPITAL FLOWS AND THE CAPITAL ACCOUNT. CANADIANS (HOOD) CRITICIZED SECRETARIAT FOR NOT BEING SUFFICIENTLY CONSCIOUS OF THE ROLE OF CAPITAL FLOWS, PARTICULARLY AS A FACTOR OF LONGER TERM FINANCING OF CURRENT ACCOUNT DEFICITS ON A SUSTAINABLE BASIS. GERMANS AND JAPANESE POINTED TO CAPITAL EXPORTS AS USEFUL OFFSET TO THEIR CURRENT ACCOUNT SURPLUSES (WEBER LAMENTING THE FACT THAT THE CONCEPT OF THE "BASIC BALANCE" HAD FALLEN INTO DISUSE). ITALIANS (PALUMBO) HOWEVER NOTED THAT CAPITAL EXPORTS WHILE USEFUL TEMPORARILY, SHOULD NOT BE ACCEPTED AS A PERMANENT WAY OF ADJUSTING CURRENT ACCOUNT BALANCES AMONG INDUSTRIALIZED COUNTRIES LEST THE ADJUSTMENT PROCESS BECOME ASYMMETRICAL. U.S. (NORDHAUS) STATED THAT INTRA-OECD FINANCING OF SURPLUSES BY CAPITAL EXPORTS

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WAS INCONSISTENT WITH TODAY'S OVERALL PAYMENTS STRUCTURE IN WHICH OECD AREA AS A WHOLE IS IN DEFICIT. WORLD SAVING NOW TAKES PLACE LARGELY THROUGH THE OPEC SURPLUS AND IT IS HARD TO SEE HOW THE OECD AREA AS A GROUP CAN ELIMINATE THE OPEC SURPLUS QUICKLY. THUS, THE CURRENT ACCOUNT EXPECTATIONS OF INDIVIDUAL OECD COUNTRIES HAVE TO BE ADJUSTED TO THIS NEW REALITY.

CAPITAL CONTROLS

29. THERE WAS SOMEWHAT OF A SPLIT IN THE WP-3 ON THE QUESTION OF WHETHER CAPITAL CONTROLS CAN BE A USEFUL

DEVICE TO HELP STABILIZE EXCHANGE MARKETS. MCMAHON
THOUGHT THAT SWISS AND JAPANESE MEASURES HAD HAD
SOME EFFECT BUT THAT SWISS CONTROLS MAY HAVE DEFLECTED
SOME OF THE PRESSURE ON TO THE JAPANESE. HOOD AND
WALLICH INDICATED STRONG SKEPTICISM WITH WALLICH NOTING

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AMEMBASSY ROME
AMEMBASSY STOCKHOLM
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THAT SIMILARLY TO WATER IN THE BATHTUB, FINANCIAL
FLOWS WOULD ONE WAY OR ANOTHER GET AROUND CONTROLS AND
FIND THE LEVEL DETERMINED BY BASIC FORCES. MATSUKAWA
TRIED TO DRAW A DISTINCTION BETWEEN CONTROLS ON SHORT-
TERM CAPITAL, WHICH HE FELT THERE MIGHT BE SOME
UTILITY UNDER CERTAIN CIRCUMSTANCES, AND CONTROLS ON
LONG-TERM CAPITAL, WHERE THE CASE WAS LESS EVIDENT.

OTHER ITEMS AND DATE OF NEXT MEETING.

30. FRENCH DEL (HABERER) MADE ONLY SHORT
INTERVENTION AND KEPT HIS REMARKS MOSTLY TO SITUATION

OF FRANCE. HE WELCOMED THE INCREASE IN FRENCH
RESERVES OF ABOUT \$1 BILLION OVER APRIL - MAY SINCE
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RESERVE LEVEL IS RELATIVELY LOW AT ABOUT ONLY ONE
MONTH'S IMPORTS. THE ADJUSTMENT PROCESS WAS WORKING
BUT IS SLOW BECAUSE THE REAL INCOME OF WAGE EARNERS
IS BEING MAINTAINED.

31. IN ANSWER TO QUESTIONS ON THE STATE OF U.S. ENERGY
POLICY, U.S. (NORDHAUS) REVIEWED THE CURRENT STATUS OF
U.S. ENERGY LEGISLATION IN THE CONGRESS. HE NOTED
THAT POLICY OBJECTIVE OF THE U.S. IS TO BRING DOMESTIC
ENERGY PRICES TO THE LEVEL OF WORLD MARKET PRICES (OR
ABOVE) AND THAT WE ARE COMMITTED TO GET THERE IN TWO
YEARS' TIME. SOLOMON ADDED THAT WE EXPECTED TO PROGRESS
TOWARD THIS GOAL IN PHASES WHICH MIGHT TAKE TWO YEARS
TO COMPLETE, BUT THAT THIS DID NOT MEAN THAT WE WOULD
WAIT TWO YEARS TO GET THERE.

32. THE CHAIRMAN OF THE TEMPORARY WORKING PARTY
(VAN YPERSELE) REPORTED ON THE RECENT TWP DISCUSSION
ON THE BALANCE OF PAYMENTS POSITIONS OF THE SMALLER
OECD COUNTRIES. HIS REPORT WAS ALONG LINES
INDICATED IN REF D.

33. WP-3 DECIDED TO MEET IN WASHINGTON ON SEPTEMBER 23
PRIOR TO IMF ANNUAL MEETING.
SALZMAN

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TAGS: ECON, EFIN, OECD
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